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No. 93-823

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of Nebraska

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, NATIONAL CONFERENCE OF STATE LEGISLATURES, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL ASSOCIATION OF COUNTIES, U.S. CONFERENCE OF MAYORS, AND NATIONAL GOVERNORS' ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

RICHARD RUDA *
Chief Counsel
LEE FENNELL
STATE AND LOCAL LEGAL CENTER
444 North Capitol Street, N.W.
Suite 345
Washington, D.C. 20001
(202) 434-4850
* *Counsel of Record for the* Amici Curiae

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Pursuant to Rule 37.4 of the Rules of this Court, *amici* respectfully move this Court for leave to file the attached brief *amicus curiae* in support of petitioner. Petitioner has consented to the filing of this brief. This motion is made necessary by the refusal of respondent to consent to the filing.

Amici are organizations whose members include state, county, and municipal governments and officials throughout the United States. *Amici* have a compelling interest

in legal issues that affect state and local governments. Among the most important of such issues are those involving the scope of federal limitations on state and local taxing authority. The Nebraska Supreme Court's reading of 31 U.S.C. § 3124 would prohibit state taxation of mutual fund income derived from repurchase agreements involving federal securities, and would thereby eliminate a source of tax revenue currently relied upon by many States.* Moreover, the Nebraska Supreme Court's interpretation would stretch the doctrine of intergovernmental tax immunity to unprecedented lengths by extending it to taxes that consider neither a federal obligation nor interest on a federal obligation.

Because *amici* and their members have a compelling interest in these issues, *amici* submit this brief to assist the Court in its resolution of this case.

Respectfully submitted,

RICHARD RUDA *
Chief Counsel
LEE FENNELL
STATE AND LOCAL LEGAL CENTER
444 North Capitol Street, N.W.
Suite 345
Washington, D.C. 20001
(202) 434-4850
* *Counsel of Record for the Amici Curiae*

May 3, 1994

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* Express judicial or administrative authority supports the taxation of repurchase income in many States. *See, e.g., Department of Revenue v. Page*, 541 So.2d 1270 (Fla. Dist. Ct. App. 1989); *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987), *cert. denied*, 485 U.S. 960 (1988); *Hammond Lead Products v. State of Indiana Tax Comm'rs*, 575 N.E.2d 998 (Indiana 1991); *Everett v. Department of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 578 A.2d 192 (Md. 1990); Massachusetts Ltr. Rul. 81-82 (Sept. 1, 1981), 1991 Mass. Tax LEXIS 39; Michigan Ltr. Rul. 87-68 (June 6, 1987), 1987 Mich. Tax LEXIS 114; *Massman Constr. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *Trust for Short-Term U.S. Government Securities v. Minnesota Dep't of Revenue*, No. 89-1317 (Dist. Ct. Hennepin County 1989); New York Tech. Servs. Mem. TSB-M-88-(5)I (June 8, 1988), *cited in* TSB-A-89-(4)I, 1989 N.Y. Tax LEXIS 311; N.C. Admin. Code tit. 17, r. 06B.0116(1); *Pastore v. Limbach*, Ohio Bd. of Tax Appeals, No. 89-G-310 (May 3, 1991), *reprinted in* 27 Ohio Tax Reports (CCH) ¶ 400-916 (Sept. 16, 1991), 1991 Ohio Tax LEXIS 835; Oklahoma Tax Comm'n 89-09-26-16/Prec. (Sept. 26, 1989), 1989 Okla. Tax LEXIS 24; *Borg v. Department of Revenue*, 774 P.2d 1099 (Or. 1989); South Carolina Rev. Rul. 91-15 at 6-7 (Sept. 18, 1991), 1991 S.C. Tax LEXIS 58; *Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue*, 429 N.W.2d 551 (Wis. App. 1988); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Re: Ruling Request—Exempt Interest and Dividends*, P.D. 87-186 (Cir. Ct. Buchanan County, Va.) (July 7, 1987), 1987 Va. Tax LEXIS 107.

The Federation of Tax Administrators anticipates publishing a report containing complete data on state tax treatment of repurchase agreement income received through mutual funds. Federation of Tax Administrators, *State Taxation of Income from Mutual Funds or Money Market Accounts Invested in U.S. Government Securities: A Revised Report* (forthcoming Summer 1994).

QUESTION PRESENTED

Whether a state tax imposed on mutual fund shareholder income derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 or the constitutional doctrine of intergovernmental tax immunity.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	v
INTEREST OF THE *AMICI CURIAE*	1
STATEMENT	1
SUMMARY OF ARGUMENT	4
ARGUMENT	6
STATUTORY AND CONSTITUTIONAL PRINCIPLES OF INTERGOVERNMENTAL TAX IMMUNITY DO NOT PROHIBIT STATES FROM TAXING INCOME OF MUTUAL FUND SHAREHOLDERS DERIVED FROM REPURCHASE AGREEMENTS INVOLVING FEDERAL SECURITIES	6
A. State Taxes Imposed On Mutual Fund Income Derived From Repurchase Agreements Do Not Violate Section 3124, Because Their Computation Does Not Require Consideration Of A Federal Obligation Or The Interest On A Federal Obligation	8
B. The Taxation Of Repurchase Agreement Income Does Not Interfere With The Borrowing Power Of The Federal Government Or The Investment Attractiveness Of Federal Obligations In Violation Of Section 3124 Or Principles Of Intergovernmental Tax Immunity	12
1. There Is No Evidence That State Taxation Of Repurchase Income Impedes The Borrowing Power Of The Federal Government Or Reduces The Investment Attractiveness Of Federal Securities	13

TABLE OF CONTENTS—Continued

	Page
2. An Attenuated Impact On Borrowing Power Or Investment Attractiveness Would Be Insufficient To Confer Tax Immunity On Repo Income Under Section 3124 Or The Constitution	18
C. Principles Of Intergovernmental Tax Immunity Require That The Federal Tax Treatment Of Repurchase Income Involving Municipal Bonds Be Analyzed In The Same Manner As State Tax Treatment Of Repurchase Income Involving Federal Obligations	24
CONCLUSION	26

TABLE OF AUTHORITIES

Cases	Page
American Bank and Trust Co. v. Dallas County, 463 U.S. 855 (1983)	8, 10, 11
American Nat'l Bank of Austin v. United States, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970)	25
California State Bd. of Equalization v. Sierra Summit, Inc., 490 U.S. 844 (1989)	12
Commissioner of Internal Revenue v. P.G. Lake, Inc., 356 U.S. 260 (1958)	10
Denman v. Slayton, 282 U.S. 514 (1931)	23, 25
Educational Films Corp. v. Ward, 282 U.S. 379 (1931)	24
First Nat'l Bank of Atlanta v. Bartow County Bd. of Tax Assessors, 470 U.S. 583 (1985)	*passim*
Gilmore v. State Board of Administration of Florida, 382 So. 2d 861 (Fla. Dist. Ct. App. 1980)	16
Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939)	7-8, 17-18, 21-22
Gregory v. Helvering, 293 U.S. 465 (1935)	10
Helvering v. F & R Lazarus & Co., 308 U.S. 252 (1939)	10
Helvering v. Gerhardt, 304 U.S. 405 (1938)	22
In re Bevill, Bresler & Schulman Asset Management Corp., 67 B.R. 557 (D.N.J. 1986)	*passim*
James v. Dravo Contracting Co., 302 U.S. 134 (1937)	7, 20, 25
McCulloch v. Maryland, 17 U.S. (4 Wheat) 316 (1819)	7, 24
Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976)	6
Missouri v. Gehner, 281 U.S. 313 (1930)	23
Plummer v. Coler, 178 U.S. 115 (1900)	18, 24
Rockford Life Ins. Co. v. Ill. Dep't of Revenue, 482 U.S. 182 (1987)	*passim*
Smith v. Davis, 323 U.S. 111 (1944)	*passim*
South Carolina v. Baker, 485 U.S. 505 (1988)	6, 24
Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970)	23, 25

TABLE OF AUTHORITIES—Continued

Page

United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) 22, 23
United States v. California, 113 S.Ct. 1784 (1993) .. 20
United States v. New Mexico, 455 U.S. 720 (1982) .. 6, 7, 20, 21
Willcuts v. Bunn, 282 U.S. 216 (1931) 9-10, 20

Statutes

31 U.S.C. § 3124 .....*passim*
Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. Law No. 98-353, § 396(a), 1984 U.S.C.C.A.N. (98 Stat.) 333, 366 (codified at 11 U.S.C. § 559) 14-15

Legislative Materials

Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary, 98th Cong., 2d Sess. (1984) 14, 15, 15-16
Bankruptcy Reform: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 98th Cong., 1st Sess. (1983) 14
H.R. Rep. No. 651, 97th Cong., 2d Sess., *reprinted in* 1982 U.S.C.C.A.N. 1895 7

Other Authorities

William F. Hagerty, IV, Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 Vand. L. Rev. 401 (1984) 3
Elizabeth M. Osenton, Note, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection With Economic Reality*, 36 Am. U. L. Rev. 669 (1987) 9, 15, 17
Marcia Stigum, *The Money Market* (3d ed. 1990) ..2, 9, 17
Marcia Stigum, *The Repo and Reverse Markets* (1989) .....*passim*

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INTEREST OF THE *AMICI CURIAE*

The interest of the *amici* is set forth in the motion accompanying this brief.

STATEMENT

Amici adopt petitioner's statement of the case, and provide only the following discussion of points relevant to *amici*'s argument.

A repurchase agreement or "repo" is a two step transaction, both parts of which are agreed to by the parties at the outset. *See* J.A. 11-12 ¶¶ 10-12. In the first step, Party A provides funds to Party B, in exchange for securities owned by B. J.A. 11 ¶ 11.[1] The amount which A gives B is typically less than the amount the securities owned by B are actually worth. Marcia Stigum, *The Money Market* 580 (3d ed. 1990); J.A. 12 ¶¶ 15-17; J.A. 33-34. In step two, A returns the securities to B, and B returns the funds to A, along with "interest"—an amount representing the value of B's use of the funds for the elapsed period of time. Stigum, *The Repo and Reverse Markets* at 26; J.A. 12 ¶ 12. This "interest" is the repo income which Nebraska, like most other States, seeks to tax.

The rate of interest paid in connection with the repurchase transaction "does not bear any relationship to the interest rate or yield paid on the underlying security, but rather is based on the prevailing market rate paid on investments or financing transactions of similar maturity and risk." *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 567 (D.N.J. 1986). The interest paid on the securities themselves by the federal government is at all times considered the income of the original owner of the securities. If the lender/buyer receives such interest on the securities during the repurchase term, it is handed over to the original owner. *See* Stigum, *The Repo and Reverse Markets* at 319; J.A. 69 ¶ 9.

Although denominated a "repurchase," there is general agreement throughout the financial community that the transaction operates, in economic essence, like a collateralized loan. *See, e.g.*, Stigum, *The Money Market*

[1] Although the securities involved in this case are federal securities, municipal bonds and other instruments may also be the subject of repurchase agreements. *See* discussion *infra* at 24-26; Marcia Stigum, *The Repo and Reverse Markets* 333-34 (1989) (discussing litigation involving municipal bond repos); Marcia Stigum, *The Money Market* 587 (3d ed. 1990).

at 577 ("Despite the fact that repos and reverses take the form of sequential sales and repurchases of securities, everyone on the Street agrees that the *economic essence* of the transaction is that it is a *collateralized loan*, not a pair of securities trades.").

The Federal Reserve Board participates in repurchase agreements to effect short-term adjustments in the nation's money supply. *See generally* Marcia Stigum, *The Repo and Reverse Markets* 90-96 (1989); William F. Hagerty, IV, Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 Vand. L. Rev. 401, 403-04 (1984). Repurchase agreements which do not involve the Fed, however, do not serve this purpose. Such repos are viewed as alternatives to other forms of credit for the parties involved, and are used either to obtain the use of funds for a short time period, or to invest funds for short-term use by another party. *See* Stigum, *The Repo and Reverse Markets* at 107-110, 312-313; Hagerty, *Lifting the Cloud of Uncertainty*, 37 Vand. L. Rev. at 404.

This case involves Nebraska's efforts to tax income derived from private repurchase agreements entered into by two mutual funds, the Trust for Short Term U.S. Government Securities and the Trust for U.S. Treasury Obligations (the "Trusts"). Pet. 2-3. There has been no suggestion that the Fed was a party to any of the repurchase agreements at issue here. Indeed, Loewenstein describes the Trusts in which he invested as "secondary dealers," *see* Opp. 8; such "secondary dealers do not deal directly with the Federal Reserve." *Bevill*, 67 B.R. at 568; *see* Opp. 8.

SUMMARY OF ARGUMENT

1. Section 3124 prohibits any form of state taxation that "would require the [federal] obligation, the interest on the obligation, or both, to be considered in computing a tax . . . ." 31 U.S.C. § 3124(a). The tax which Nebraska has imposed upon mutual fund income derived from repurchase agreements involving federal securities falls outside the scope of this prohibition, because it does not consider the underlying federal obligation or interest paid on that obligation. Instead, the income earned in connection with a repurchase agreement represents the value associated with the use of a sum of money for a given period of time. *See* Stigum, *The Repo and Reverse Markets* at 26 ("The difference between the purchase and sale prices on the repo transaction is the interest the investor earns on his loan.").

Whether a repurchase agreement is characterized in accordance with its clear economic purpose and effect (*i.e.*, as a loan collateralized by a federal obligation), or viewed as unique hybrid transaction that involves a matched sale and repurchase designed to achieve the same effect as a loan, money paid in connection with a private repo reflects one thing only—the value associated with the use of a sum of money for an agreed period of time. By construing Section 3124 to exempt income from such private transactions from state taxation, the Nebraska Supreme Court flatly disregarded this Court's repeated admonition that the statutory exemption not be "expanded or modified in any degree by the judiciary[.]" *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 191-92 (1987) (quoting *Smith v. Davis*, 323 U.S. 111, 119 (1944)).

2. Respondent relies on an erroneous interpretation of language in *Smith* to argue that repo income is entitled to tax-exempt status under Section 3124. There, in assessing the types of government obligations encompassed within Section 3124's prohibition, the Court noted

"the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." 323 U.S. at 117. Respondent's attempt to translate that statement into a ban on state taxation of repo income is unavailing for two reasons.

First, no evidence has been presented in this case that would indicate a State's taxation of repo income would have any deleterious effect on the "market value" or "investment attractiveness" of federal obligations. The affidavit of Peter D. Sternlight, upon which respondent and the Nebraska Supreme Court place primary reliance, *see* Opp. 7-9 & App. A; Pet. App. 7-8, was prepared for a bankruptcy proceeding and contains no evidence whatsoever as to the effect of state taxation on the repo market, and offers no opinion on that subject. Moreover, because repos are uniquely attractive investment instruments which have no close substitutes, it is unlikely that state taxation would cause investors to turn away from them in sufficient numbers to have any impact on the market for the underlying federal obligations.

Second, respondent's reading of the statement in *Smith* is inconsistent with precedents of this Court, both before and after *Smith*, holding that an attenuated or indirect effect on the federal government's borrowing power is insufficient to confer immunity from taxation. *See, e.g., Rockford*, 482 U.S. at 190. Moreover, the Court has repeatedly declined to read intergovernmental tax immunity doctrines as sheltering otherwise taxable income. *See, e.g., First Nat'l Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583, 595-96 (1985). The Court has never required States to go beyond the statutory and constitutional requirements to grant additional tax advantages to holders of federal securities and those with whom they deal; failure to grant such added advantages does not "diminish" the attractiveness of the obligations in the sense prohibited by Section 3124.

3. Granting tax-exempt status to repo income involving federal obligations will create a double standard in violation of principles of intergovernmental tax immunity unless repo income involving municipal bonds is similarly exempted from federal taxation. In analyzing assertions of tax immunity involving either the federal government or state and local governments, the Court uses the same standard to determine "whether a tax is 'on' a government." *South Carolina v. Baker*, 485 U.S. 505, 518 n.11 (1988). Hence, if principles of intergovernmental tax immunity are held to require the serious encroachment on the taxing power of the States urged by respondent, they would also necessarily require that the same limitation be placed on the taxing power of the federal government where repos involving municipal bonds are concerned, thereby calling into question the validity of a line of federal appellate cases holding to the contrary.

ARGUMENT

STATUTORY AND CONSTITUTIONAL PRINCIPLES OF INTERGOVERNMENTAL TAX IMMUNITY DO NOT PROHIBIT STATES FROM TAXING INCOME OF MUTUAL FUND SHAREHOLDERS DERIVED FROM REPURCHASE AGREEMENTS INVOLVING FEDERAL SECURITIES

The modern doctrine of intergovernmental tax immunity rests on the core tenet that "absent congressional action, we have emphasized that the States' power to tax can be denied only under 'the clearest constitutional mandate.'" *United States v. New Mexico*, 455 U.S. 720, 738 (1982) (quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976)). Because the Court has indicated that Congress' enactment of Section 3124 did not expand the reach of intergovernmental tax immunity beyond its narrow constitutional confines,[2] before examining that

[2] The prior codification of Section 3124 was viewed as coextensive with the constitutional doctrine of intergovernmental tax immunity. *See, e.g., First Nat'l Bank*, 470 U.S. at 593 ("[T]his Court consistently has 'treated [§ 3701] as principally a restatement of the constitutional rule.'") (citations omitted). The legislative history of the statutory provision's 1982 recodification as Section 3124 indicates that no substantive change was intended. *See id.* at 585 n.1; H.R. Rep. No. 651, 97th Cong., 2d Sess. 94, *reprinted in* 1982 U.S.C.C.A.N. 1895, 1988.

statute it is appropriate to revisit "the underlying constitutional principle" which it embodies. *New Mexico*, 455 U.S. at 733. That principle, as the Court has emphasized, exists within "narrow constitutional limits," *id.* at 737, and serves a very specific, limited purpose—"that of forestalling 'clashing sovereignty,' by preventing the States from laying demands directly on the Federal Government." *Id.* at 735 (quoting *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 430 (1819)). Accordingly, the Constitution prohibits only those taxes which "would be 'a direct interference with the functions of government itself.'" *Id.* at 736 (quoting *James v. Dravo Contracting Co.*, 302 U.S. 134, 157 (1937)).

This "narrow approach to governmental tax immunity accords with competing constitutional imperatives, by giving full range to each sovereign's taxing authority." *Id.* at 735-36. And, as the Court explained in the landmark case of *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939), a narrow construction of intergovernmental tax immunity is especially important to avoid unwarranted encroachment on the taxing power of the other sovereign, where, as here, the principle of intergovernmental tax immunity is invoked for the benefit of a private citizen:

> [T]he implied immunity of one government and its agencies from taxation by the other should, as a principle of constitutional construction, be narrowly restricted. For the expansion of the immunity of the one government correspondingly curtails the sovereign power of the other to tax, and where that immunity is invoked by the private citizen it tends to operate for his benefit at the expense of the taxing

government and without corresponding benefit to the government in whose name the immunity is claimed.

Id. at 483 (citations omitted). Here, the encroachment on the taxing power of the States proposed by respondent cannot be squared with this limited constitutional principle of intergovernmental tax immunity. Because Section 3124 is no broader in scope than this underlying constitutional principle, an analysis of the Nebraska tax under this statute yields the same conclusion.

A. State Taxes Imposed On Mutual Fund Income Derived From Repurchase Agreements Do Not Violate Section 3124, Because Their Computation Does Not Require Consideration Of A Federal Obligation Or The Interest On A Federal Obligation

Section 3124 clearly defines the scope of the tax exemption at issue here: A state or local government is prohibited from imposing any "form of taxation that would require the [United States government] obligation, the interest on the obligation, or both, to be considered in computing a tax . . . ." 31 U.S.C. § 3124(a). The plain meaning of this statutory provision is that a state or local government may not "take[] into account, or include[] in the accounting" the value of the federal obligation itself or the interest earned on that obligation in determining tax liability. *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

Computation of the Nebraska tax on Loewenstein's income does not require consideration of any federal obligation or the interest on any federal obligation. Income derived from repurchase agreements is paid for the use of money for a specified time period, and is unrelated to the yield or interest rate of the underlying security. *See* Stigum, *The Repo and Reverse Markets* at 318; *Bevill*, 67 B.R. at 567. Repo income represents a sum paid for the use of the money, not interest paid by the federal government on the underlying exempt obligation. Even during the repurchase term, the interest paid on the federal obligation itself (which is, of course, not subject to taxation by Nebraska) is passed through to the original owner of the securities. *See* Stigum, *The Repo and Reverse Markets* at 319; J.A. 69 ¶ 9. In private repos, such as the ones implicated here, the transaction is designed to do nothing more than permit one party to have the use of a given sum of money for a specified period of time. *See* page 3, *supra*; Stigum, *The Repo and Reverse Markets* at 107-110.

Whatever its form, the economic substance of a repurchase, like that of any arrangement designed to allow one party to use funds provided by another party for a given period of time, is a loan. *See, e.g.*, Stigum, *The Money Market* at 577; J.A. 30 (Sternlight deposition); Elizabeth M. Osenton, Note, *The Need For A Uniform Classification Of Repurchase Agreements: Reconciling Investor Protection With Economic Reality*, 36 Am. U. L. Rev. 669, 689 (1987). The federal obligation is not "purchased" or "sold" in any economically meaningful sense; instead, it serves as collateral for a loan. This becomes clear when key factors such as the risks borne by each party, the "sales" price, the amount of "interest" paid, and the treatment of interest on the underlying security, are considered. The way in which these features are handled in the repurchase transaction is economically explicable only when the transaction is viewed as a collateralized loan. *See, e.g.*, Stigum, *The Repo and Reverse Markets* at 311-32; Pet. Br. at 23-32.[3]

[3] Even if the Court were to view the repurchase agreement as a purchase and sale of a federal obligation, however, Loewenstein would still not be entitled to a tax exemption. If the transaction were characterized in this manner, the difference between the amount he initially "paid" for the federal security and the amount he ultimately "sold" it back for would represent a capital gain. Capital gains on federal obligations are not tax exempt. Because such "gain[s] may be regarded as 'the creation of capital, industry and skill,' " a tax on them is not "on the obligations of the [government], or on the investment therein" and does not violate principles of intergovernmental tax immunity. *Willcuts v. Bunn*, 282 U.S. 216,

As this Court has noted, it is the economic substance of a transaction that controls its treatment for tax purposes rather than the form that the transaction takes. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities . . . ." *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 255 (1939). *See also Commissioner of Internal Revenue v. P.G. Lake, Inc.*, 356 U.S. 260, 266-67 (1958) (substance of arrangements controls rather than form; "[t]heir essence is determined not by subtleties of draftsmanship but by their total effect"); *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935). This is consistent with Congress' rejection, in the field of intergovernmental tax immunity, of formal distinctions that are economically meaningless. *See American Bank and Trust Co.*, 463 U.S. at 862.

But whether or not the characterization of a repurchase agreement as a collateralized loan is accepted, the fact remains that repo income does not represent a federal obligation or its interest, but income from a private transaction for the use of money for a given period of time. Hence, even if this Court were to decide that a repurchase is better characterized as a purchase and resale, rather than a loan, this characterization would not be determinative for Section 3124 purposes. Section 3124 does not provide a blanket immunity from taxation for "owners" of federal securities; even an "owner" of a federal security is only entitled to exemption from taxes the computation of which requires consideration of the federal security or the interest earned thereon. Regardless of how a repo is characterized, the income that it generates stems from neither of these sources; instead it is money that one party pays another for the privilege of using money for a certain time period.

In arguing that Section 3124 nevertheless requires that a tax exemption be granted repo income, respondent, like

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228 (1931) (citation omitted); *see* Br. *Am. Cur.* State of California, *et al.* at 13-17.

the Nebraska Supreme Court, relies on the statute's prior wording, which expressly banned every form of taxation that required the federal obligation or interest on the obligation to "be considered, directly or indirectly, in the computation of the tax . . . ." *See* Pet. App. 9; Opp. 10. This language, which was added in a 1959 amendment, did away with formalistic distinctions having no basis in economic reality, so as to ban taxes which were, in economic effect, placed upon federal securities or the interest earned thereon. *See American Bank*, 463 U.S. at 858, 862. Because Congress indicated that its 1982 recodification of the statute (which omitted the words "directly or indirectly") was intended to work no substantive change, *see* note 2, *supra*, respondent is correct in asserting that Section 3124 continues to ban forms of taxation that require the "indirect" consideration of a federal security or the interest thereon.

Here, however, computation of Nebraska's tax does not involve even the "indirect" consideration of a federal security or interest on a federal security—the interest paid in connection with a repurchase is paid for use of a sum of money for a period of time and represents neither a federal security nor its interest or yield. The Nebraska Supreme Court reached the opposite result only by stripping the word "indirectly" of its statutory context and reading it as an open-ended ban on any tax placed on income even "indirectly" linked to a federal obligation. As the Court made clear in *First National Bank*, however, the words "directly or indirectly" were not intended to "broaden the scope" of the statutory prohibition beyond its narrow constitutional bounds, but only "to abolish the formalistic distinction between taxes *on* income and taxes *measured* by income." 470 U.S. at 593-94. Hence, the 1959 amendment did not exempt additional forms of income from state taxation; it only clarified that States were precluded from imposing any form of taxation, whether direct or indirect, on those narrow categories of income set forth in the statute. *See id.* at 594 (no indica-

tion in legislative history "that Congress understood the addition actually to broaden the scope of the exemption, as well as to clarify the forms of taxes to which the exemption applied").

The Nebraska Supreme Court's extension of tax-immune status to repurchase agreements, despite Section 3124's clear language limiting the tax exemption to federal obligations and interest on federal obligations, represents precisely the type of judicial broadening of intergovermental tax immunity that the Court has repeatedly warned against. As the Court admonished in *Smith*, Congress' "intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government[,] . . . . which is largely codified in § 3701, should not be expanded or modified in any degree by the judiciary." 323 U.S. at 119, *quoted in Rockford*, 482 U.S. at 191-92. *See also California State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 851-52 (1989) ("[W]e have stated that '[a] court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed.' ") (citing *Rockford*, 482 U.S. at 191). *Cf. Smith*, 323 U.S. at 117 ("Tax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under Section 3701 is necessary under these circumstances.").

B. The Taxation Of Repurchase Agreement Income Does Not Interfere With The Borrowing Power Of The Federal Government Or The Investment Attractiveness Of Federal Obligations In Violation Of Section 3124 Or Principles Of Intergovernmental Tax Immunity

Despite the clearly limited language of Section 3124, respondent argues that this Court has read the provision in a manner that would nonetheless shield repo income from taxation. Specifically, respondent relies on this Court's statement in *Smith*, referencing "the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." 323 U.S. at 117. Respondent then contends that Nebraska's taxation of repo income falls within this prohibition because it would impair the federal government's borrowing capacity and the attractiveness of its obligations. This argument is unavailing for two reasons: there is no evidence to support it, and it is based on a misreading of this Court's precedents.

1. *There Is No Evidence That State Taxation Of Repurchase Income Impedes The Borrowing Power Of The Federal Government Or Reduces The Investment Attractiveness Of Federal Securities*

Both respondent and the Nebraska Supreme Court rely primarily on testimony of Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (FRBNY), that was submitted in another case, in contending that Nebraska's taxation of repurchase income impedes the borrowing power of the federal government and makes federal securities less attractive. *See* Opp. 7-9 & App; J.A. 22-43. But Sternlight's affidavit, which was prepared in the context of a bankruptcy proceeding, totally fails to support respondent's contention or the Nebraska Supreme Court's conclusion.[4]

Most importantly, Sternlight's affidavit offers no opinion whatsoever as to the effect of state taxation on re-

[4] As the Nebraska Supreme Court explained, the testimony of Peter Sternlight upon which it relied was given in a deposition conducted in another case involving the same issue, *Page v. Department of Revenue, State of Florida*, No. CI 87-2586, which was litigated in the Circuit Court of the Ninth Judicial Circuit, Orange County, Florida. Pet. App. 7. That deposition, however, centered on an affidavit which Sternlight had prepared in connection with yet another proceeding, *Bevill*, 67 B.R. 557, a bankruptcy case. *See* J.A. 23-28 (Sternlight deposition); J.A. 39-43 (Sternlight affidavit).

purchase agreements. This is not surprising, since the affidavit was prepared in a case involving a bankruptcy question. The "hobbling of the repo market" warned of in ¶ 7 of the affidavit, J.A. 42, references not the effect of taxation, as respondent would have this Court believe, but uncertainty as to the effect of bankruptcy on repurchase agreements. This is clear not only from the context in which the affidavit was prepared, but also from the fact that Sternlight's testimony in a Congressional hearing involving proposed bankruptcy amendments tracks, almost verbatim, his statements in this portion of the affidavit. *Compare Bankruptcy Reform: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 314-15 (Statement of Peter D. Sternlight) (1983) [hereinafter Senate Hearing] *with* J.A. 42 ¶ 7.

In the Senate Hearing, Sternlight outlined the problems that could affect the repo market if the uncertainty surrounding bankruptcy treatment were not resolved:

> More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency in the allocation of resources. Market participants would turn to less liquid forms of investment or more costly sources of funds—in either case tending to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could also add to average rate levels.

Id. Sternlight then went on to testify in the Senate Hearing that these problems could best be resolved by "modify[ing] the Bankruptcy Code . . . ." *Id.* at 315.[5]

[5] *See also Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 98th Cong., 2d Sess. 50-58 (Statement of Peter D. Sternlight) (1984) [hereinafter House Hearing]. Statutory amendments to the Bankruptcy Code have alleviated many of the liquidity concerns raised by Sternlight in his testimony in Congressional hearings. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. Law No. 98-353, § 396(a), 1984 U.S.C.C.A.N. (98 Stat.) 333, 366 (codified at 11 U.S.C. § 559); Osenton, *The Need for a Uniform Classification*, 36 Am. U. L. Rev. at 684 ("By passing section 559, Congress restored the liquidity that repo investors and the economy need and expect.").

Sternlight's response to questions involving taxation further clarify that his testimony was not directed at the consequences of tax treatment. During his deposition in the *Page* case, he responded to a question about the federal tax treatment of repo income by disclaiming any "expert familiarity" in that area. J.A. 31. Similarly, in a letter submitted in connection with a Congressional hearing involving proposed bankruptcy amendments, he indicated that the amendments would have no effect on the characterization of repurchase agreements for tax purposes. *See* House Hearing at 106 (letter of Peter D. Sternlight to Hon. Peter W. Rodino, Jr.) ("While I would not want to claim expertise on the treatment of repos for tax purposes, it seems to me that the enactment of H.R. 2852 and 3418 should not affect the characterization of repos under the tax laws . . . .").

Nor does Sternlight's affidavit suggest that the characterization of repurchase agreements as loans for Section 3124 purposes would trigger untoward consequences; his discussion of the dangers of a "secured loan" characterization, *see* J.A. 41 ¶ 5, were made in a case where the characterization of repos for bankruptcy purposes was at issue. The characterization for tax purposes, which is based on the economic essence of a transaction, need not be binding in other settings where factors other than economic essence are important. Indeed, the Fed's own characterization of repos as sales and repurchases in the bankruptcy context is not viewed as controlling in other contexts, such as taxation. *See* House Hearing at 106-07 (letter of Peter D. Sternlight) ("while the Federal Reserve has gone on record as favoring purchase-and-sale characterization of repurchase agreements, that statement

is limited to a bankruptcy context and should not be taken as an endorsement of purchase-and-sale characterization for tax, accounting, or other purposes"); *see also* Stigum, *The Repo and Reverse Markets* at 325 (discussing contexts in which Fed "describes the repos it does as *credit* transactions that add to bank reserves").[6]

The Sternlight affidavit is not probative of the finding of the court below that a "state tax on [repo] income would diminish the market value and investment attractiveness of federal securities . . . [and] impose a burden on the federal government's regulation of the nation's money supply." Pet. App. A-13. It is therefore a wholly insufficient basis for extending intergovernmental tax immunity to the repurchase agreement income of private parties under the language of *Smith v. Davis*. The Court has flatly rejected the notion that a prohibited effect on the marketability or attractiveness of government obligations can be inferred from the mere withdrawal of a tax benefit, in the absence of supporting evidence. In *First National*

[6] The idea that repos might be characterized differently in the bankruptcy and taxation areas is easily explained. In the bankruptcy context, the parties' intent is an important part of the characterization determination, whereas in taxation, economic substance alone controls. *See Bevill*, 67 B.R. at 594 (distinguishing tax cases characterizing repos as collateralized loans in which courts had found that "the parties' intent underlying their contractual relations was not relevant to the legal characterization of the transaction for federal income tax purposes," from bankruptcy cases in which "the intent of the parties is a central consideration" and "[c]onsiderations relating to the economic substance of the transactions, while relevant to this determination, are certainly not controlling") (citations omitted). *See also Gilmore v. State Board of Administration of Florida*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (characterization of repurchase agreement applicable in default context might not be appropriate in tax context). The exclusive focus on economic substance in the tax context is driven by the need to preclude tax avoidance by the taxpayers through creative formulation or labelling of their dealings. *See Bevill*, 67 B.R. at 594 (noting that the courts in tax cases "were concerned with the tax avoidance possibilities associated with the transactions and focused their attention solely on their economic substance").

Bank, for example, the Court found that there was no evidence indicating that the removal of a tax shelter would be enough to "prompt banks to forgo the advantages of federal obligations, such as their extreme liquidity and safety, and to invest their money elsewhere." 470 U.S. at 597.[7]

The same analysis applies here. Repurchase agreements are a uniquely attractive financial tool in a wide variety of investment contexts. *See, e.g.*, Osenton, *The Need for a Uniform Classification*, 36 Am. U. L. Rev. at 670-71 ("Retail repos give investors what they want most—liquidity, security, and high-yield.") (footnote omitted); Stigum, *The Repo and Reverse Markets* at 107-114 (describing unique attractiveness of repos for different types of investors). Indeed, many investors, including state and local governments, may be prohibited from engaging in other types of investments and may view repos as their most attractive alternative. *See* Stigum, *The Money Market* at 589; J.A. 42-43, ¶ 8 (Sternlight affidavit). The absence of attractive substitutes for repurchase agreements suggests that state tax treatment is unlikely to influence many investors. *Cf. First Nat'l Bank*, 470 U.S. at 597. In fact, many States have taxed repurchase agreements for years, *see* footnote to attached Motion, yet there is no indication that investors are turning to other alternatives as a result.

In the absence of any indication that state taxation of repo income will adversely affect the federal government's borrowing power, there is no basis for the immunization of private repurchase agreements from taxation. As the Court explained in *Graves*, "it is plain that there is no basis for implying a purpose of Congress to exempt the

[7] The Court also noted that allowing the sheltering of otherwise taxable income under the auspices of § 3701 could lead a State to alter its tax strategy to place heavier reliance on the types of taxes expressly exempted from § 3701's prohibition on taxation; this would make the net effect on investment attractiveness uncertain. *First Nat'l Bank*, 470 U.S. at 596-97.

federal government or its agencies from tax burdens which are unsubstantial or which courts are unable to discern." 306 U.S. at 480. And, as *Rockford* recently reaffirmed,

> [W]hen effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

482 U.S. at 190 n.10 (quoting *Plummer v. Coler*, 178 U.S. 115, 137-38 (1900)). There has been no showing in this case of an obvious and appreciable impairment of the power of the federal government.

2. *An Attenuated Impact On Borrowing Power Or Investment Attractiveness Would Be Insufficient To Confer Tax Immunity On Repo Income Under Section 3124 Or The Constitution*

Contrary to the Nebraska Supreme Court's holding and respondent's assertions, principles of intergovernmental tax immunity do not require the automatic invalidation of any state tax that might have even the slightest and most attenuated impact on the federal government's borrowing power or on the investment attractiveness of federal obligations. Hence, even if there were some slight marginal impact on the investment attractiveness of federal obligations flowing from Nebraska's taxation of repurchase agreement income, this would not be determinative as a matter of constitutional or statutory law. Respondent's contentions to the contrary are based on a misreading of this Court's precedents.

As a preliminary matter, it is quite significant that the Court's statement in *Smith v. Davis* regarding Congressional intent to prohibit taxes that would "diminish in the

slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit," 323 U.S. at 117, was made not in the context of forbidding taxes with an indirect or attenuated impact on government obligations, but in the context of determining Congressional intent as to the *types* of government obligations exempted from taxation. The Court's words can most fairly be read in this context as emphasizing that Congress sought to protect the value of certain types of obligations (*i.e.*, those issued by the United States in an effort to secure necessary credit) from being eroded through taxation, and that it had therefore shielded such obligations (and *only* such obligations) from taxation.

This reading is consistent with the language Congress used to define the boundaries of the tax exemption, which evidences no intent to encompass all taxation that is indirectly linked to or that might affect, in even the most highly attenuated fashion, a government obligation. Given the Court's insistence—in the very same paragraph of the *Smith* decision—on clear language to evidence Congress' intent to create a tax exemption, and its holding in *Smith* that the challenged state tax did not violate either constitutional or statutory principles of intergovernmental tax immunity, it is wholly implausible that the Court intended for its words to signal the vast and unprecedented expansion of tax immunity attributed to them by respondent and the court below. *See* 323 U.S. at 117. Indeed, it is impossible to square either the Court's holding or its closing admonition in the *Smith* case with such an interpretation:

> All of these related statutes are a clear indication of an intent to immunize from state taxation *only* the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government. That intent, which is largely codified in Section 3701, should not be expanded or modified in any degree by the judiciary.

Id. at 119 (emphasis added), *quoted in Rockford*, 482 U.S. at 191-92.

The Court's holdings, in cases both prior and subsequent to *Smith*, further clarify that the fact that a tax might have some attenuated impact on the value or attractiveness of federal obligations does not render it impermissible under statutory or constitutional principles of intergovernmental tax immunity. *See, e.g., Rockford*, 482 U.S. at 190 (any possible effect that taxation of Ginnie Maes might have on borrowing ability of the United States was "far too attenuated to support constitutional immunity"); *Willcuts v. Bunn*, 282 U.S. 216, 225 (1931) (power to tax should not be needlessly crippled "where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government").[8]

Moreover, the Court has emphasized that "[t]he tax exemption required by the Constitution and § 3701 is not a tax shelter." *First Nat'l Bank*, 470 U.S. at 597. Thus, its statement in *Smith v. Davis* that every form of taxation is prohibited which would "diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States," must be read as a prohibition only on affirmative tax erosion of the

[8] *Cf. United States v. New Mexico*, 455 U.S. at 734 (Tax immunity "may not be conferred simply because the tax has an effect on the United States."), *quoted in Rockford*, 482 U.S. at 191 n.11; *United States v. California*, 113 S.Ct. 1784, 1788-89 (1993) (Although the federal government "is absolutely immune from direct taxes, it is not immune from taxes merely because they have an 'effect' on it, or 'even because the Federal Government shoulders the entire economic burden of the levy' . . . . Tax immunity is 'appropriate in only one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities.' ") (citations omitted); *James v. Dravo Contracting Co.*, 302 U.S. 134, 160 (1937) (fact that a tax imposed on a government contractor may increase the cost to the government does not render it invalid).

value of federal securities and the interest that they earn. In other words, the baseline or starting point which may not be diminished by taxation (and which Nebraska has not sought to tax) is the federal obligation and the interest that it earns. Clearly, a State does not violate principles of intergovernmental tax immunity because it fails to provide *added* tax benefits to holders of federal securities or those with whom they deal, simply because this could be said to "diminish" the value or attractiveness of the federal security compared to what it might be if those added tax benefits were granted.[9]

Such a failure to bestow extra tax advantages is obviously not the type of prohibited diminishment that the Court spoke of in *Smith*. Yet respondent's contention that taxation of repo income would diminish the value or attractiveness of federal obligations, even if true, suffers from this same fallacy. Repo income does not represent a federal obligation or interest earned thereon, and hence is not part of the baseline protected by constitutional and statutory principles of intergovernmental tax immunity. States are not required to maximize the attractiveness of federal obligations by granting special tax benefits to all who come into contact with them; they are only required to abide by the constitutional and statutory rule that taxation not erode the value of the federal obligations themselves or the interest that the obligations generate and thereby constitute "a direct interference with the functions of government itself." *New Mexico*, 455 U.S. at 736 (citation omitted).

As the Court explained in *Graves*, in the context of taxes imposed on government employees, the

[9] For example, it is obvious that exempting holders of federal obligations from state income tax on any of their earnings (whether related to the federal obligations or not) would make holding a federal obligation more attractive. Consequently, failing to provide those benefits could be said to "diminish" the attractiveness of the obligations compared to the attractiveness they would enjoy if those benefits were provided.

> purpose of [intergovernmental tax] immunity was not to confer benefits on the employees by relieving them from contributing their share of the financial support of the other government, whose benefits they enjoy, or to give an advantage to that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other.

306 U.S. at 483 (footnote omitted) (citing *Helvering v. Gerhardt*, 304 U.S. 405 (1938)). And in *First National Bank*, the Court reaffirmed this "fair share" idea by holding that States may, through their tax laws, "charg[e] tax-exempt obligations and interest their fair share of related expenses or burdens." 470 U.S. at 593 (footnote omitted).[10]

Accordingly, taxpayers' attempts to shelter income by acquiring tax exempt securities as liabilities have been rebuffed by the Court. In *First National Bank*, the Court upheld a Georgia tax based on banks' net worth which permitted only the deduction of the pro rata share of tax-exempt securities that represented assets. If a full tax exemption were allowed for all federal securities, the Court found, banks could shelter otherwise taxable assets and avoid their fair share of the tax burden by acquiring federal securities as liabilities. *See id.* at 596-97.

The *First National Bank* decision thus reaffirmed the "fair share" theme that had appeared in prior decisions involving efforts to obtain extra tax benefits through the borrowing of money to purchase tax-exempt securities.

[10] *Cf. United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 251 (1965) ("The doctrine of intergovernmental immunity does not require such a [tax] benefit to be conferred on the ownership of municipal bonds."); *Helvering v. Gerhardt*, 304 U.S. at 421 (collecting cases in which "[t]he fact that the expenses of the state government might be lessened if all those who deal with it were tax exempt was not thought to be an adequate basis for tax immunity").

See Atlas Life, 381 U.S. at 247; *Denman v. Slayton*, 282 U.S. 514 (1931). The *First National Bank* Court also clarified that it had adopted the dissenting view of Justice Stone in *Missouri v. Gehner*, 281 U.S. 313 (1930). *See* 470 U.S. at 591. In *Gehner*, Justice Stone stated that "[t]he immunity of government bonds from taxation does not carry with it immunity from liability for debts." 281 U.S. at 323 (Stone, J., joined by Holmes and Brandeis, JJ., dissenting) (citation omitted).

This case involves a similar effort to reap a second tax advantage from government securities, and thereby to avoid paying a fair share of taxes on income from a private credit arrangement. *Cf. Union Planters Nat'l Bank of Memphis v. United States*, 426 F.2d 115, 116 (6th Cir.) (if income on repos involving municipal bonds were not taxable, taxpayers "would be able to enjoy the benefit of the double tax advantage which Congress intended to prevent"), *cert. denied*, 400 U.S. 827 (1970). Here, not only does the original owner of the government securities continue to receive a tax exemption for interest paid on the government instrument during the term of the repurchase agreement, but the respondent also seeks to claim a tax exemption for the interest he receives from the holder of the government securities for the use of his money during the repurchase term.

In sum, the notion that intergovernmental tax immunity can be used to obtain double tax benefits by incurring liabilities to obtain tax-exempt securities has been soundly rejected. *See, e.g., First Nat'l Bank*, 470 U.S. at 596. In legal and economic effect, it makes no difference that in this case the interest Nebraska seeks to tax is paid not on a loan taken out to *buy* government securities, but on a loan taken out to increase cash flow *after buying* tax exempt government securities (for which those securities are used as collateral). *See Union Planters*, 426 F.2d at 116 (tax exemption for repo income would circumvent Congress' purpose of preventing double tax benefit in IRC § 265(2)).

C. Principles Of Intergovernmental Tax Immunity Require That The Federal Tax Treatment Of Repurchase Income Involving Municipal Bonds Be Analyzed In The Same Manner As State Tax Treatment Of Repurchase Income Involving Federal Obligations

Constitutional principles of intergovernmental tax immunity work not only to protect the instrumentalities of the federal government from state and local taxation, but also to protect state and local government instrumentalities from federal taxation. *See, e.g., Educational Films Corp. v. Ward*, 282 U.S. 379, 392 (1931) ("the purpose [of intergovernmental tax immunity] is the preservation to each government, within its own sphere, of the freedom to carry on those affairs committed to it by the Constitution, without undue interference by the other") (collecting cases).

Although the scope of the intergovernmental tax immunity afforded state and local governments is not always identical to that afforded the federal government, *see, e.g., McCulloch*, 17 U.S. (4 Wheat.) at 435-36, the Court has noted that "federal and state tax immunity cases have always shared the identical methodology for determining whether a tax is 'on' a government, and . . . this identity has persisted even though the methodology for both federal and state immunities has changed as intergovernmental tax immunity shifted into the modern era." *South Carolina v. Baker*, 485 U.S. at 518 n.11. *See also Plummer*, 178 U.S. at 117 ("[t]he reasoning upon which these two lines of decision proceed is the same").

Therefore, the question of whether the income on a repurchase agreement involving government securities is too attenuated from the exempt security itself to warrant tax immunity is a question which should be answered in exactly the same manner for the federal taxation of repurchase income involving municipal bonds, as for the state taxation of repurchase income involving federal securities. *Cf. First Nat'l Bank*, 470 U.S. at 591 (applying

doctrine set forth in a case involving the federal taxation of municipal bonds to question involving state taxation of federal obligations) (citing *Denman v. Slayton*, 282 U.S. 514 (1931)); *Dravo Contracting*, 302 U.S. at 157 ("While the Metcalf Case was one of a federal tax, the reasoning and the practical criterion it adopts are clearly applicable to the case of a state tax upon earnings under a contract with the federal government.").

Federal appellate courts considering the question of the federal taxation of income from repurchase agreements involving municipal bonds have consistently held that such income is taxable, despite the exemption granted to municipal bond interest in the Internal Revenue Code. *See, e.g., Union Planters*, 426 F.2d at 118; *American Nat'l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); Stigum, *The Repo and Reverse Markets* at 334 & n.2 (collecting cases). In so holding, these federal courts have used reasoning that closely parallels that used by state courts holding that repurchase income is taxable. *See, e.g., American Nat'l Bank of Austin*, 421 F.2d at 452 ("In short, taxpayer was in effect a lender secured by collateral in its possession. Under these circumstances, we would be blinding ourselves to reality if we did not see quite clearly that taxpayer's role here was that of a lending institution . . . ."); *Union Planters*, 426 F.2d at 118 (repos "will be regarded as secured loans for federal income tax purposes"). *See also* Stigum, *The Repo and Reverse Markets* at 334 ("In the cases that the [federal] government won, the courts treated the [municipal bond] repos in question as collateralized loans rather than as purchases and sales of securities. The focus of the courts in those cases was on the *economic substance* of the repo transactions.").

If the Court prohibits Nebraska from taxing respondent's repo income, it will inevitably call into question the federal government's ability to tax repo income involving municipal bonds, upheld in the foregoing cases. Equality

of treatment in the two instances is required as a matter of logic and law, since the same reasoning concerning whether the repurchase income is closely enough linked to the underlying instrument to take on its tax exempt status is applicable in challenges to the taxing authority of either sovereign.

CONCLUSION

The judgment of the Nebraska Supreme Court should be reversed.

Respectfully submitted,

RICHARD RUDA *
Chief Counsel
LEE FENNELL
STATE AND LOCAL LEGAL CENTER
444 North Capitol Street, N.W.
Suite 345
Washington, D.C. 20001
(202) 434-4850
* *Counsel of Record for the* Amici Curiae

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